Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Assy. Rev. & Tax Comm.	Analyst:	Jeani Brent	Bill Number:	AB 1637
Related Bills:	SB 94, AB 1208 (1999)	Telephone:	845-3410	Amended Date:	09/09/1999
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Eliminate TMT Limitation on Personal Exemption Credit/Renter's Credit Technical Clean Up

SUMMARY OF BILL

This bill would do the following:

1. Eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax (TMT).

2. Delete obsolete refund provisions relating to the renter's credit that are no longer necessary because the reinstated renter's credit, enacted by AB 2797 (Stats. 1998, Ch. 322), is not refundable.

3. Include a reference in Revenue and Taxation Code Section 17039 to Section 17053.30. This reference would have provided that a land and water conservation credit could reduce regular tax below TMT. However, SB 680, in which the land and water conservation credit was contained, was not passed by the Legislature. Thus, this provision is unnecessary.

SUMMARY OF AMENDMENT

The September 9, 1999, amendments removed the provisions relating to sales taxes and replaced them with the provisions discussed in this analysis.

EFFECTIVE DATE

This bill would become effective immediately and would apply to taxable years beginning on or after January 1, 1999.

POSITION

Support.

At its December 16, 1998, meeting, the Franchise Tax Board voted 2-0 to sponsor the personal exemption credit provision.

ISSUE #1: Eliminate TMT Limitation On Personal Exemption Credit

PROGRAM HISTORY/BACKGROUND

In 1987, California enacted legislation that established an Alternative Minimum Tax (AMT) in lieu of the previous tax on preference income. The California legislation substantially conformed state law to the AMT provisions in effect at

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the federal level, which had been adopted as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income could completely avoid tax liability by using exclusions, deductions, and credits (tax preference items). As discussed below, taxpayers are allowed an AMT exemption deduction in computing AMT. Prior to 1997, the AMT exemption deduction amounts were: $40,000 for married taxpayers filing joint returns; $30,000 for individuals filing as either single or as a head of household; and $20,000 for married taxpayers filing separate returns. These AMT exemption deduction amounts were increased in 1997 to $45,000 for married taxpayers filing joint returns; $33,750 for individuals filing as either single or as a head of household; and $22,500 for married taxpayers filing separate returns. Also, the AMT exemption deduction amounts will be adjusted for inflation after the 1999 taxable year.

The AMT essentially is a mechanism for recapturing some of the tax benefits available to higher-income taxpayers. Although these tax benefits are allowed under current law, the AMT effectively limits the extent to which, when taken collectively, they can reduce tax liability.

The AMT can affect tax liability in either or both of two ways: First, an AMT liability can be assessed in excess of the taxpayer’s regular tax liability. Second, the AMT calculation can result in a reduction in the amount of tax credits that a taxpayer is allowed, thus effectively increasing regular tax.

Differences between the structure of state and federal laws necessitate some differences between state and federal AMT provisions. One difference is the treatment of the personal exemption. State law allows a personal exemption in the form of a credit; federal law provides a personal exemption in the form of a deduction. For federal AMT purposes, the personal exemption deduction may not be used in the calculation of alternative minimum taxable income (AMTI). State law conformed to this federal provision by not allowing the personal exemption credit to reduce regular tax below tentative minimum tax (TMT).

To claim personal exemption credits, taxpayers must first calculate their TMT to determine whether their credits will be limited. The interaction of AMT with the personal exemption credit adds complexity to personal income tax return preparation for approximately 3 million taxpayers who must make the calculation only to determine that their personal exemption credit is not limited by TMT. This interaction also increases the tax liability of approximately 30,000 moderate-income taxpayers whose personal exemption credits would be reduced by the TMT interaction.

Prior to 1997, each exemption credit amount (personal, dependent, blind) was the same. For the 1997 taxable year, each exemption credit amount was $68. The credit amount is adjusted annually for inflation.

In 1997, SB 1233 (Ch. 612) increased the dependent exemption credit amount to $120 for the 1998 taxable year and to $222 beginning in the 1999 taxable year. The increased credit was not to be adjusted for inflation for the 1999 taxable year.

In 1998, AB 2797 (Ch. 322) increased the dependent exemption credit amount from $120 to $253 for the 1998 taxable year and from $222 to $227 for the 1999 taxable year and thereafter. The increased credit will be adjusted for inflation after the 1999 taxable year.

SPECIFIC FINDINGS

Existing federal law provides five tax brackets ranging from 15% to 39.6%. It also provides a two-tiered personal income AMT rate system. The AMT rate is 26% of the "taxable excess" that does not exceed $175,000 and 28% of the "taxable excess" that exceeds $175,000. "Taxable excess" is the amount of alternative minimum taxable income (AMTI) that exceeds the exemption deduction. The exemption deduction allowed against AMTI is: $45,000 for married taxpayers filing joint; $33,750 for single or head of household taxpayers; and $22,500 for married taxpayers filing separate.

Prior to 1998, under federal law the nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit) were allowed only to the extent that the individual's regular tax liability exceeded the individual's TMT. For tax years beginning in 1998, federal law allows the nonrefundable personal credits to offset the individual's regular tax in full.

Existing state law provides six tax brackets ranging from 1% to 9.3% and a personal income AMT rate of 7%.

California AMT is calculated by increasing regular taxable income by specific tax preference items and making other adjustments for items for which treatment differs under AMT rules. The resulting figure is AMTI, from which an AMT exemption deduction is subtracted. The AMT exemption deduction amounts vary depending on filing status and are indexed annually for inflation. For 1997, the AMT exemption deduction amounts are: $45,000 for married taxpayers filing joint returns; $33,750 for individuals filing as either single or as a head of household; and $22,500 for married taxpayers filing separate returns. The exemptions are phased out for taxpayers with adjusted gross income over specified amounts. The excess of AMTI over the AMT exemption deduction, multiplied by the 7% AMT rate, is TMT. Tentative minimum tax is compared to regular tax before credits; the amount by which TMT exceeds regular tax before credits is the alternative minimum tax. The Personal Income Tax Law (PITL) provides a variety of credits, some of which may be used to reduce the regular tax below TMT. However, the law specifies that certain credits cannot reduce regular tax to an amount less than the TMT. In effect, taxpayers lose some of the value of the credits that may not be carried forward and may not reduce regular tax below TMT.

Existing state law provides various exemption credits against tax, including a personal exemption and exemptions for dependents, blind persons, and individuals 65 or older. Exemption credit amounts are allowed as follows for the 1998 taxable year:

Exemption Type	Amount (1998)
Personal	$70
Blind	$70
Dependent	$253

The exemption credit amounts are indexed annually for inflation as measured by changes in the California Consumer Price Index. Exemption credits are not refundable and may not be carried over to future years. Exemption credits are subject to two limitations:

1. Exemption credits begin to phase out at federal AGI levels over the amounts listed below:

Filing Status	AGI (1998)
Single/Head of Household	$161,044
Married Filing Separate	$107,362
Married Filing Joint	$214,725

2. Exemption credits are limited to the amount by which regular tax before credits exceeds tentative minimum tax (TMT).

This provision would eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax.

Policy Considerations

This bill would ensure that 30,000 additional moderate-income taxpayers would be able to take full advantage of recently increased dependent exemption amounts. Also, this bill would reduce the complexity of filing a PIT return by eliminating the need for approximately 3 million moderate-income taxpayers, with no preferences, to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

Implementation Considerations

The implementation of this provision would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

To the extent this provision would reduce the number of telephone calls from taxpayers regarding how to complete the complex AMT calculation (Schedule P) and the number of errors that must be addressed during return processing, it would generate cost savings.

Tax Revenue Estimate

Based on tax model simulations, eliminating the TMT interaction with regard to all exemption credits would result in revenue losses of $1.5 million annually beginning with the 1999-2000 fiscal year, benefiting approximately 30,000 filers.

This provision would eliminate the need for approximately 3 million taxpayers to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

ISSUE #2: Renter's Credit

SPECIFIC FINDINGS

AB 2797 (Stats. 1998, Ch. 322) changed the renter's credit from a refundable tax credit to a nonrefundable tax credit. However, language relating to a refundable renter's credit was inadvertently retained in the renter's credit (Section 17053.5) and in the credit ordering provision (Section 17039). In addition, a section relating to the denial of the refundable renter's credit was not repealed (Section 19052).

This provision would remove the obsolete language and repeal the obsolete section relating to the refundable renter's credit.

Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not impact the department's costs.

Tax Revenue Estimate

As a technical correction, this provision would not impact PIT revenues.